

V. Settlements ⁵⁶

A settlement based on a taxpayer's inability to pay the entire amount of the liability may be entered into either before or after entry of judgment. Before negotiating the terms of a settlement, the trial attorney must obtain information as to the taxpayer's financial situation.

A. Sources of Financial Information

1. Statement of Financial Condition and Other Information (DJ-TD 433 (1996))

In all cases, the taxpayer should be required to submit a Statement of Financial Condition and Other Information (DJ-TD 433 (1996)), a copy of which is attached as Exhibit 15. Rule 69 interrogatory answers containing up-to-date financial information are also sufficient in lieu of the Statement of Financial Condition and Other Information. If the amount of the Government's concession, based on collectibility, is \$50,000 or more, including accrued statutory interest, the IRS should be requested to verify the financial information, unless the trial attorney has determined, as set forth in a memorandum to the file, that the information disclosed by the taxpayer is substantially correct. If the amount of the liability sought to be compromised is less than \$50,000, including accrued statutory interest, the IRS should be requested to verify the financial information only if the information disclosed appears to be inaccurate in light of other information available to the trial attorney.

2. Income Tax Returns

The trial attorney should obtain, either from the IRS or the taxpayer, copies of the taxpayer's income tax returns for the last five years. In some cases, it may be advisable to obtain copies of the income tax returns for all years beginning with the year to which the liability relates to assist in verifying that fraudulent conveyances have not been made.

⁵⁵ (...continued)

legislative fix to this problem. In the meantime, however, the Department can collect the surcharge using state-law collection remedies as authorized by Rule 69 of the Federal Rules of Civil Procedure.

⁵⁶ See also the Tax Division's Settlement Reference Manual.

3. Applications for Loans

If the taxpayer has obtained loans, the trial attorney should obtain copies of the loan applications.

4. Taxpayer Owned Businesses

If the trial attorney is aware that the taxpayer owns a controlling interest in a business, the trial attorney should request the taxpayer to provide a financial statement for the business so the income and/or the liquidation value can be taken into account.

B. Terms of Settlement

1. Cash Payments

In negotiating a settlement, the trial attorney should attempt to maximize the amount that the taxpayer will pay shortly after acceptance of the offer and minimize utilization of installment or deferred payment agreements. If the settlement includes an installment or deferred payment agreement, the unpaid amount generally should include statutory interest from the date of acceptance of the offer.

2. Collateral Agreements

A collateral agreement should be considered in any proposed settlement based upon the taxpayer's inability to pay. It enables the Government to recover part or all of the difference between the amount of the offer and the liability settled. The theory underlying the collateral agreement is that since the balance of the taxpayer's liability will be abated once the taxpayer satisfies the terms of the offer, it is reasonable to expect that the taxpayer will agree to pay additional sums from future income or to give up potential tax benefits as additional consideration for acceptance of the offer. The total amount which can be recovered under an offer and collateral agreement is the equivalent of the total liability compromised, plus interest and additions to tax that would have accrued in the absence of the settlement. There are two different types of collateral agreements discussed in the following sections.

a. Contingent Payments Based on Future Income

Future income collateral agreements are frequently used. Copies of the forms Collateral Agreement--Future Income-Individual and Collateral Agreement--Future Income-Corporation are attached as Exhibits 22 and 23. Under the terms of a future income collateral

agreement, a taxpayer is obligated to pay, for each year the agreement is in force, graduated percentages (generally ranging from 20% to 50%) of "annual income" in excess of a threshold amount or floor.

The threshold or floor at which percentage payments begin to be due must be negotiated with an individual taxpayer in each case. Among the factors to be considered by the Government are the number of dependents, expected changes in the size of the family, number of wage earners in the family, FICA taxes withheld, and unusual expenses, such as alimony, child support, and abnormal medical and dental costs. The completed Form DJ-TD 433 (1996) will contain information concerning living expenses. Note, however, that the purpose of the threshold is not to maintain the taxpayer's present living standard, which may be extravagant, but to allow the taxpayer to retain a reasonable amount of income before payments under the collateral agreement become due. IRS Special Procedures should be contacted as they have knowledge of what terms are accepted in a particular area and the local cost of living. A typical provision for an individual taxpayer might be as follows:

- (a) Nothing on the first \$25,000 of annual income;⁵⁷
- (b) 20 percent of annual income more than \$25,000 and not more than \$30,000.
- (c) 30 percent of annual income more than \$30,000 and not more than \$40,000.
- (d) 40 percent of annual income more than \$40,000 and not more than \$50,000; and
- (e) 50 percent of annual income more than \$50,000.

For a corporation, the usual threshold or floor is \$10,000, and the agreement usually provides for the payment of 30% of annual income more than \$10,000 and less than \$15,000, and 50% of annual income exceeding \$15,000.

⁵⁷ Generally, the threshold or floor amount set forth in subparagraph (a) should be no higher than the taxpayer's current income less the estimated amount of federal, state, and local income taxes. If a taxpayer is presently unemployed but is still able to work and has an employment history showing the ability to realize substantial earnings, a threshold amount may be set taking all circumstances into account.

Future income collateral agreements, for both individuals and corporations, usually run for a period of ten taxable years. A shorter period (no less than five years) can be considered in individual cases where, for example, the taxpayer is elderly and retired or will soon retire.

The term "annual income" is defined in the text of the collateral agreement itself to include, inter alia, all nontaxable income, including the fair market value of gifts, bequests, devises and inheritances. Annual income is reduced by federal, state, and local income taxes reportable for the year for which annual income is being computed, provided that such taxes have been reported and paid. Annual income is further reduced by any regular monthly, annual, or other periodic payment made under the settlement for the year in which such payment is made. It is usually advisable to use the standard definition on the collateral agreement form.

A future income collateral agreement is appropriate in those situations where it appears reasonably likely that the taxpayer will have future annual income over and above the taxpayer's necessary living expenses during the period of the agreement. Therefore, if a taxpayer is presently unemployed but is still able to work and has an employment history showing the ability to command annual income greater than the threshold amount, a collateral agreement should be negotiated. On the other hand, if the taxpayer has a lengthy work history and has never earned income greater than the threshold amount, a collateral agreement may not be in the Government's best interests. Generally, where the taxpayer is making a lump sum payment and has no prospects of future earnings, collateral agreements will not be required merely because an unlikely event may occur, such as the winning of a lottery or the unexpected inheritance of assets in the future (although it may be appropriate if the inheritance is substantial and appears reasonably likely to occur during the period of the collateral agreement).

Under the terms of the future income collateral agreement, each year the agreement is in force the taxpayer is required to submit to Special Procedures a sworn statement of annual income and a copies of the taxpayer's current federal, state, and local income tax returns for the year for which annual income is being computed. Copies of the annual income forms for individuals and corporations are attached as Exhibits 24 and 25.

After the trial attorney has received the executed collateral agreement, the trial attorney should send the original and two copies of the executed collateral agreement to IRS Special Procedures for monitoring of the agreement. A copy of a

form letter is attached as Exhibit 26. Copies of the agreement should be placed in both the DJ file and the trial attorney's personal file.

b. Waiver of Carryover of Losses and Credits

Where the taxpayer has incurred net operating losses or capital losses for years ending before the date on which the offer will be accepted, and/or the taxpayer has any unused credits from any such prior years, a collateral agreement waiving any carryover of such losses and credits should be considered. This collateral agreement should be used only when the taxpayer is not executing a collateral agreement as to future income as a part of the settlement, since the collateral agreement as to future income contains a waiver of carryover of losses and credits. A copy of the Collateral Agreement--Waiver of Carryovers is attached as Exhibit 27.

3. Waiver of Deductions

If a case is being settled on the basis of taxpayer's inability to pay, an asset that the taxpayer can offer in settlement is waiver of any deduction for federal tax purposes for the payments made pursuant to the settlement.

4. Security for Amounts Due Under Compromise

A settlement including deferred or installment payments and/or a collateral agreement should provide for security for the taxpayer's obligations under the settlement.⁵⁸ Thus, tax liens should not be released. In negotiating a settlement before judgment has been entered, the trial attorney generally should have the taxpayer agree to entry of judgment for the full amount of the Government's claim. If judgment is not to be entered, the taxpayer must waive the benefit of any statute of limitations applicable to the assessment and collection of the liability sought to be

⁵⁸ Abstracts of judgments and other security received for payments, whether received before or after settlement, should be filed and/or recorded in the appropriate districts or other appropriate local offices, except if the settlement provides otherwise. Originals of legal documents, such as mortgages, notes, letters of credit, and insurance policies, should be preserved in a Tax Division safe, and the trial attorney should prepare a memorandum to the file setting forth the location of the document.

compromised and agree to the suspension of the running of the statutory period of limitations on assessment and collection for the period during which the offer in compromise and the settlement are pending, or the period during which any payment due under the settlement remains unpaid, or any provision of the settlement is not carried out in accordance with its terms, and for one year thereafter.

The settlement should provide that the judgment will be marked satisfied after the judgment debtor has completed all obligations under the settlement, including any collateral agreement.

The settlement should set forth the Government's options in the event of default by the taxpayer. These options are set forth in the collateral agreement form. If the taxpayer will not be executing a collateral agreement as a part of the settlement, the settlement should set forth the appropriate options.

C. Form Acceptance Letters and Stipulations

Form acceptance letters to the proponent, the United States Attorney, and the IRS are attached as Exhibits 28, 29, and 30. Form stipulations of dismissal are attached as Exhibits 31 and 32. Form stipulations for judgment are attached as Exhibits 5 and 6.

D. Settlements Requiring Payments to the Government

When the terms of settlement require payments to the Government, the trial attorney should give some thought to where the payments should be sent by the taxpayer and who will be responsible for monitoring the receipt.

Taxpayers generally should be directed to send to the Tax Division the following categories of payments:

1. Lump-Sum Payments. A lump-sum payment is a single payment to be made within a specified time, such as 30 days after the date of acceptance or upon the happening of an event, such as the sale of property or the termination of probate proceedings. If the payment is due upon the happening of an event which is not likely to occur within a short period of time, it may be advisable to direct the taxpayer to send the payment to Special Procedures.
2. Initial Payments. An initial payment is a payment which is to be made within a specified short time,

after which installment payments will be made for a prolonged period, e.g., a payment of \$30,000 due within 30 days after acceptance, followed by monthly payments of \$500 until the liability is paid in full.

3. Installment payments concluding within six months of acceptance.
4. The first installment payment of an installment payment agreement extending beyond six months should be sent to the Tax Division; the remaining installment payments should be sent to Special Procedures.

Taxpayers generally should be directed to send directly to Special Procedures the following categories of payments:

1. All installment payments, after the first installment payment, where payments will be made over a period of more than six months.
2. Payments due under a collateral agreement as to future income.
3. Any other payment not specified above as a payment to be sent to the Tax Division.

Addresses and telephone numbers of Special Procedures are attached as Exhibit 33.

It is the responsibility of the trial attorney, with the assistance of a paralegal, to monitor the receipt of payments which are directed to the Tax Division and to take appropriate measures on default.

E. Closing Cases After Settlement

Upon receipt of all payments due to be paid directly to the Tax Division (or if all payments are to be made to the United States Attorney or the IRS, then, upon acceptance of the settlement offer), the case should be closed in the Tax Division. Thus, if all payments are to be made to Special Procedures, the case should be closed and referred to Special Procedures for monitoring of the settlement agreement and receipt of the payments, including payments that may be due under a collateral agreement. Special Procedures should be requested to advise the Tax Division upon any default by the taxpayer or upon receipt of the final payment due so that any judgment entered may be marked satisfied. If all payments pursuant to a settlement are to be made to the United States

Attorney, the trial attorney should close the case in the Tax Division and refer it to the United States Attorney.

F. When Full Payment is Made

When the taxpayer has fully complied with the terms of the settlement, the trial attorney should:

1. File a satisfaction of any judgment involved or request the United States Attorney to do so, or dismiss the Government's claim;
2. Request the IRS to release the liens against the taxpayer for the liability at issue in the case, or discharge the fund or property involved from the liens against the taxpayer for the liability at issue in the case;
3. If the case is pending in the Tax Division, close the case as fully paid, with concurrent advice or closing to the IRS and the United States Attorney; and
4. Request the United States Attorney to arrange for the release of any existing judgment lien.

G. Default on a Settlement

Normally, the section chief has the authority to determine when the taxpayer is in default on a settlement. In the event of a default, the trial attorney should proceed as follows:

- (1) Notify taxpayer's counsel or taxpayer that there has been a default and request that the default be cured, generally within 21 days. (A time period may be set forth in the settlement agreement.)
- (2) If the default is not timely cured, proceed to follow the remedies available upon default.